Statement of

The Honorable Patrick J. Toomey
President, Club for Growth

On

Perspectives on Renewing Statutory PAYGO

Before the

Committee on the Budget,
United States House of Representatives

July 25, 2007

Mr. Chairman and members of the committee, thank you for inviting me. I am pleased to be here today to offer my views on the effects of reestablishing statutory PAYGO rules.

Supporters of PAYGO have long argued that PAYGO rules are necessary to reduce the federal deficit. At the outset let me say that reducing the deficit is a well-intentioned objective. That said, subjecting tax cuts to the PAYGO rule—as the Majority's proposal does—may actually take us farther away from that goal instead of bringing us closer to it, and in the process, do great harm to American prosperity.

Subjecting tax cuts to PAYGO rules will not only sound the death knell for future tax cuts, but will also result in the largest tax increase in American history. While it is technically possible to extend the current tax rates in compliance with PAYGO rules, it is clear that there is no appetite for the reduced mandatory spending that would be required. The resulting huge tax hike will not go unnoticed by the American economy. An economic downturn may well result, which could lead to a decline in federal tax revenue, leading, in turn, to much larger deficits than the path we are currently on.

Opponents of tax cuts have long resisted the inextricable connection between tax cuts and economic growth. But even a brief look at the economic benefits of the 2003 tax cuts suggests that any rule that precludes their extension and instead forces a reversion to prior, higher rates will likely have the unfortunate effect of inhibiting economic growth in this country.

A simple before and after picture does the trick. The before picture is as grey and grim as the after picture is bright. Consider the following numbers:

- Two years before the 2003 tax relief was implemented, American workers lost 2.7 million jobs—at an average of 100,000 jobs lost per months. Two years after the 2003 tax cuts, the American economy gained 4.3 million new jobs, an average of 160,000 per month. Today, we have gained over 8 million jobs since August 2003, and the economy continues to create jobs at a similar rate.
- In 2001, Gross Domestic Product growth was at a meager 1.1%. Two years after the tax cuts, GDP growth was at 3.8%.
- At the time of the 2003 tax cuts, the unemployment rate was at 6.1%. Two years after the cuts, unemployment sank to 5.1% and currently sits at 4.5%.
- Prior to the tax relief, business investment had declined for eight straight quarters. After the tax relief, it increased for 15 straight quarters, and continues to climb today.
- Since the 2003 tax cuts, the Dow Jones Industrial Average has increased nearly 80%, recently hitting a record-breaking level of 14,000.

Specifically, the tax cuts on capital gains and dividends earnings in 2003 have been a huge boon for shareholders, according to the IRS. Consider these numbers:

- Capital gains income has increased by 153.3% since the end of 2002.
- In 2005, capital gains income was $604 billion, just $11 billion below the all-time high set during the boom in the late 1990's.
- In 2005, dividend cash payments grew by more than 11%, marking the third straight year of double digit growth of S&P 500 dividend income.
- Dividend income ended 2005 at a record level of $154 billion.

Clearly, the 2003 tax cuts have played a large role in the increased economic growth in this country. But the story does not end there. Increased economic growth contributes directly to increased revenue and therefore, a reduction in the federal deficit. While opponents of the tax cuts argued (and continue to argue) that we could not afford the decrease in federal revenue resulting from the tax cuts, we saw huge revenue increases very shortly after the tax cuts were implemented, and tax revenues continue to flow into the federal coffers at an astonishing rate. Again, a quick before and after picture is instructive.

After declining from 2000 to 2003, federal tax revenue surged in 2004, 2005, and 2006. In 2004 and 2005, revenues grew by 14.6% and 11.8% respectively. To understand just how remarkable these numbers are consider that 2005 marks the first time since the mid-1980's (following the Reagan tax cuts) that our nation has generated double-digit revenue growth in consecutive years. Fortunately, this positive trend is continuing today. For the first eight months of 2007, incoming tax revenue has already increased by 6.9%.

Despite the preponderance of evidence to the contrary, opponents of tax cuts have a habit of leaning on the Congressional Budget Office projections to argue the magnitude of revenue losses that will result from tax cuts. But this is like a cripple leaning on a faulty crutch. If there is one thing that is clear from the past four years it is the CBO's inability to accurately project revenue. Consider the following numbers:

- In 2004, the CBO projected tax revenues to increase by 2%, compared with an actual increase of 5.5%
- In 2005, the CBO projected tax revenues to increase by 9.4%, compared with an actual increase of 14.6%.
- In 2006, the CBO projected tax revenues to increase by 7.4%, compared with an actual increase of 11.8%.
- In 2007, the CBO projected tax revenues to increase by 5.6%. Thus far, revenues are up by 6.9%.

Worse, the CBO radically underestimated the government's revenue intake from capital gains earnings after the 2003 tax cuts. At the time, dire warnings about the price of the cuts rang through these very halls. Instead of witnessing the fulfillment of those warnings, we have witnessed a sharp increase in revenue from capital gains—far beyond what the Joint Committee on Taxation and the Congressional Budget Office predicted.

In January of 2004, the CBO forecasted capital gains revenue to be $42 billion for 2003; $46 billion for 2004; $52 billion for 2005; and $57 billion for 2006. Actual returns were significantly higher: $51 billion in 2003; $72 billion in 2004; $97 billion in 2005; and $110 billion in 2006. In total, the CBO's forecast on capital gains revenue for 2003-2006 was off by a staggering 68%. Clearly, if we are in need of an economic projector, history has a better track record than the CBO.

The aforementioned numbers are clear and stark. It is no coincidence that federal tax revenue from capital gains earnings shot up immediately after the tax rate was lowered dramatically. Opponents of the capital gains tax cuts focused on the decreasing tax rates and assumed that tax revenue would follow suit. This is far too simplistic of an equation. Revenue taken into government is not solely dependent on the tax rates we impose, but on the tax rates as applied to income. If you broaden income by lowering rates, revenue can increase.

Of course, increased federal revenue—all else held constant—must result in a shrinking deficit. As revenue continues to flow into the federal government's coffers, the Congressional Budget Office and the Office of Management and Budget have been forced to significantly revise downward their deficit projections for 2004-2006, citing robust growth and revenues as a large reason for their revisions.

- In 2004, the OMB projected a deficit of $521 billion. The actual deficit was $412 billion, a decrease of $109 billion, or 21%.
- In 2005, the OMB projected a deficit of $427 billion. The actual deficit was $318 billion, a decrease of $109 billion, or 25%.
- For 2006, the OMB originally projected a deficit of $423.3 billion. The actual deficit was $247.7 billion, a reduction of $175.6 billion, or 41%.
- For 2006, the CBO originally predicted a deficit of $371 billion. The actual deficit was a reduction of 33%.

The relationship between tax cuts, economic growth, revenue, and the deficit are clear. Subjecting tax cuts to PAYGO rules effectively severs this relationship at the head by removing the very catalyst that helps the economy grow. If the purpose of PAYGO is to decrease the deficit—or at least hold it at bay—then ruling out future tax cuts and imposing the largest tax increase in American history is the wrong path to take. Rather than decrease the federal deficit, the Majority's PAYGO rules may actually exacerbate the very problem the Majority is trying to solve. Instead, PAYGO rules could be tantamount to legislating economic disaster.

Ultimately, the problem with the Majority's PAYGO rules is that it treats tax cuts and new government spending as equivalent. Supporters of this proposal assume that the tax cuts will cost the government a set number of dollars just like a new government program. This outlook is predicated on a static view of the world that is patently wrong. The economy is not static, but a dynamic creature. As I have demonstrated above, new tax cuts (if they are done properly) expand economic activity and can result in an actual increase in new government revenue and a reduction in the deficit. The same cannot be said for new government spending which does not (except sometimes briefly) expand economic growth—and can even have the effect of retarding it—and results in decreased revenue and an increased deficit.

But a broader point must be made about focusing excessively on budget deficits. While shrinking the federal deficit is important, it is not crucial as an end in itself, but only to the extent that it serves as a means to another end—increasing prosperity and economic growth. At the end of the day, job growth, higher incomes, and gains in family wealth are more important than the number on the federal government's ledger.

Some will argue that deficits contribute directly to the rate of economic growth and are therefore worthy of being elevated to such a high priority. Proponents of this argument claim that excessive government borrowing crowds out private borrowing and drives up interest rates, thus retarding economic growth. This can be true, but the operative word in this argument is "excessive."

A brief stroll down memory lane demonstrates the hollowness of this fear in the near term. Over the past five years, the U.S. government went from surpluses to deficits, but the interest rates tumbled at the same time. The reason for this is simple. Interest rates are driven primarily by other factors. Certainly, truly excessive debt has the potential to boost interest rates and harm economic growth, but we are far from approaching this worst-case scenario. It is important to remember that the current deficit is only 1.5% of the Gross Domestic Product and decreasing by the day.

What really matters is not the absolute size of the deficit but the size of the deficit as a percentage of the economy. This is true in most facets of life. Consider the following simple scenario: An elderly man dies, leaving his son two businesses from which to choose his inheritance. The first business is worth $500,000 and carries no debt. The second is worth $10 million, but carries $1 million in debt. Clearly, the second business is the better choice. The point of this little anecdote is that the size of the debt doesn't tell us the whole story. While no one likes debt, its presence out of context should not be the decisive factor in setting economic policy.

Finally, the real budgetary crisis facing our federal government isn't addressed by PAYGO. The real crisis is unsustainable projected growth in entitlement spending in absolute dollars and as a percentage of GDP.

While PAYGO is a well-intentioned rule, its implementation should not come at the cost of preventing economy-stimulating tax cuts, and any long-term attempt to deal with our budgetary crisis must begin with reform of our entitlement programs.

Thank you again for allowing me to comment on this important issue.